Access to foreign exchange trading has opened up exciting trading options for the retail trader. You can now trade alongside corporations and institutions in a highly liquid market that is global, traded around the clock, and highly leveraged. Before jumping into this market, however, we must understand the factors that affect the forex market. With that in mind, STOCKS & COMMODITIES *has introduced* ***Forex Focus*** *to better prepare the retail trader to participate in the currency market.*

Point & Figure For Forex

Here's an age-old charting technique that you can use effectively in the foreign exchange markets.

To trade using point & figure charts is to trade based on pure price action. One of the best-kept secrets about this granddaddy of technical analysis charting methods lies in the fact that it is ideally suited to analyzing and trading the forex market.

THE BASICS

Point & figure (P&F) charts originated in the 19th century as an innovative method for graphically plotting price action in the financial markets. One of the unique aspects of P&F charting is that generally, only the most important aspect of technical analysis — price — is recorded on the charts. Unlike the more widely used bar or candlestick charts, P&F charts customarily exclude volume, time, and open/close delineations. After all of this is left out, that which remains is just the purity of price action. With only price as the sole analytical factor, P&F charts are uniquely capable of revealing a clearer, less muddled representation of such vital technical analysis dynamics as trend, support/resistance, and breakouts.

FOREX ANALYSIS WITH POINT & FIGURE

Point & figure charts are well-suited to analyzing forex for a number of reasons. As most forex traders are aware, the global foreign exchange markets are collectively open for business 24 hours a day, providing continuous price data for traders. Because of this, there are no true open or close demarcations on a daily basis when trading currencies. Any open or close data represented on popular bar and candlestick charting software is largely arbitrary. Each broker or market-maker appoints its own daily open/close time.

Candlestick charts in particular rely to a great extent on this data to provide their unique visual patterns and signals. P&F charts, on the other hand, have no need for open or close data. In fact, these charts work best with continuously streaming and active price data, which forex arguably provides better than any other financial trading market.

Another aspect in which P&F charts prove so well-suited to forex trading lies in the exclusion of volume. Whereas equity charts traditionally display a volume histogram running below price, P&F charts have no place for volume. Point & figure purists reason that a price action breakout is just that, regardless of the volume that accompanies it. And as most forex traders are aware, there is no globally centralized exchange in currency trading; therefore, there is no accurate means of assessing marketwide volume data. So P&F charts focus exclusively upon the only available and all-important data point in forex trading — price.

IMPORTANCE OF PRICE

When price moves quickly and in one direction at a time, as is often the case in the forex market, P&F charts reveal significant trends exceptionally well. Because of the reversal criteria built into P&F methodology (which I will explain later), much of the untradable price fluctuations of price are filtered out, leaving just the clarity of directional trend movement.

Point & figure charts are constructed in a simple and elegant way that can seem confusing to bar and candlestick adherents. There are different types of P&F charts, but only the most common methodology — the three-point reversal variation — will be touched upon here.

Simply, a standard P&F chart consists of alternating columns of boxes labeled with Xs and Os. A column of Xs means that price has increased, while a column of Os means that price has decreased. As mentioned previously, P&F charts usually include only price, so the vertical *y*-axis displays price in increments that correspond to the size of each box. Since no other information other than price is generally included, the horizontal *x*-axis does not typically contain any information at all. As price moves up and down, alternating columns of Xs and Os are progressively added to the right as reversals occur.

Within this basic structure, some important customizations must be decided upon before analyzing P&F charts. The two most essential variables are box size and reversal amount.

Box size can easily be customized to suit the pricing structure of the traded instrument. In the case of forex trading,

by James Chen, CTA

a 10-pip fixed increment may be a reasonable choice for many currency pairs. This simply means that each X or O box is worth 10 pips. More specifically, this is the number of pips that the currency price needs to increase in order to add an X to a current column of Xs. Conversely, it is the number of pips that the currency price needs to decrease in order to add an O to a current column of Os. For the chart displayed in Figure 1, a 10-pip box size is used.

Reversal amount is the other customizable variable necessary for using point & figure charts. As mentioned earlier, the popular three-point reversal variation is generally utilized more often than other varieties, and the chart presented here uses this convention.

A three-point reversal simply means that another column in the opposite direction will only be started if a reversal in the current column exceeds the three-box reversal threshold, or in this case of 10-pip boxes, 30 pips. Any reversal price action with fewer is considered noise and is therefore ignored. When price oscillates less than this three-box reversal threshold, the current column remains intact until a reversal that exceeds the threshold occurs. Partly because of this unique focus on primary price action that disregards relatively minor price fluctuations, P&F charts reveal directional trend information well.

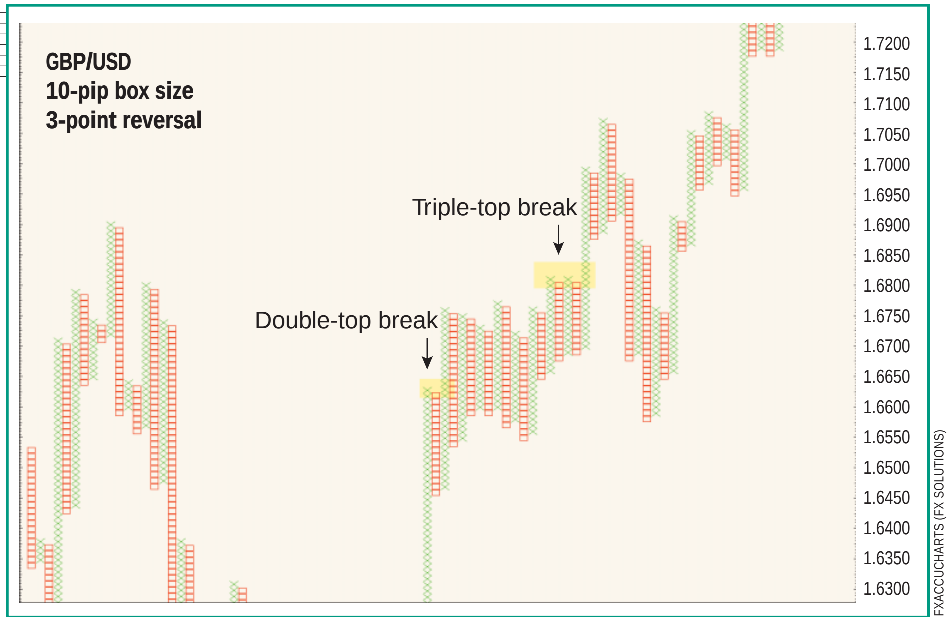

FIGURE 1: GBP/USD POINT & FIGURE CHART WITH TWO COMMON BREAKOUT PATTERNS

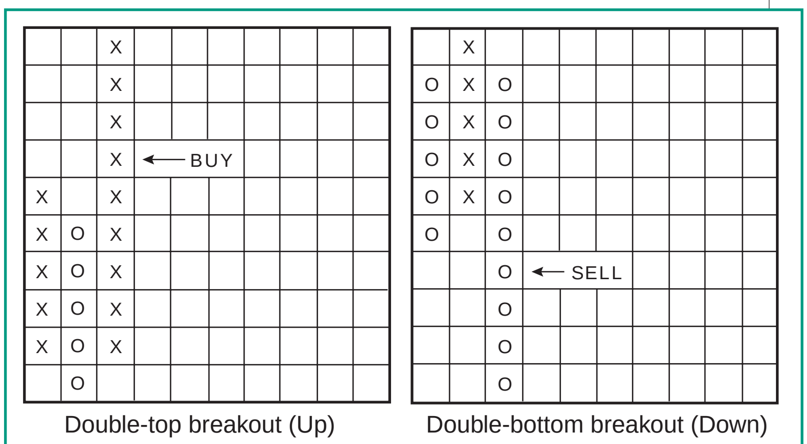

FIGURE 2: DOUBLE-TOP BREAKOUT (UP) AND DOUBLE-BOTTOM BREAKOUT (DOWN). These types of breakouts are considered potential trading opportunities in P&F charts.

Only after understanding the fundamental structure of P&F charts should traders actually turn their attention to analyzing these charts for trading purposes. Luckily, trading based upon point & figure analysis is relatively straightforward — it is predominantly about hunting for breakout opportunities. And since currency prices are often rife with breakout moves, this aspect of P&F charts fits the forex market extremely well.

P&F charts excel at outlining support and resistance levels in an efficient manner, and these support/resistance levels are measured primarily so that the point & figure analyst can pinpoint tradable breakouts. To identify these breakout opportunities, P&F traders have their own trusty toolbox of time-tested chart patterns, somewhat like those used by practitioners of other charting disciplines. Most of these P&F patterns are simple, but they can take some practice to identify on the charts.

In addition to chart patterns, P&F charts also utilize trendlines and channels extensively. But unlike trendlines on bar or candlestick charts that can be drawn at any angle, trendlines on P&F charts are drawn exclusively at 45-degree angles. Whether this uncommon characteristic makes these P&F trendlines more or less advantageous than traditional bar/candlestick trendlines is open to debate. In any event, trendlines on P&F charts can be used both to hunt for trendline breaks as well as to trade with the trend.

Whether through the use of chart patterns or trendlines, trading breakouts has most often been the primary strategy of choice for P&F practitioners. Figures 2 to 5 show a sampling of some of the most commonly analyzed and traded P&F breakout formations.

The double-top and double-bottom (Figure 2) patterns help illustrate the stark contrast between P&F charts and common bar charts. For example, a double-top on a bar chart is usually regarded as a potential reversal pattern. On P&F charts, however, it is considered a potential breakout trading opportunity. The same holds true for the triple patterns.

As traders and analysts have increasingly searched for ways to interpret the markets, P&F charts have recently enjoyed a surge of renewed popularity.

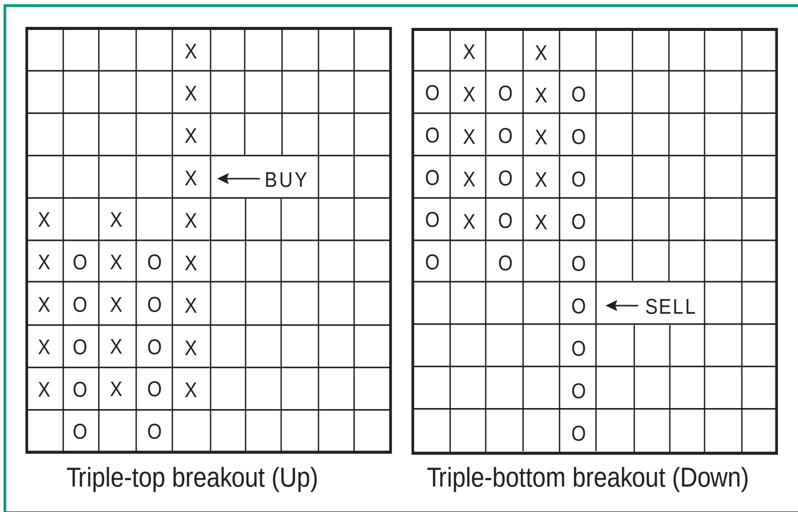

FIGURE 3: TRIPLE TOPS (UP) AND TRIPLE BOTTOMS (DOWN). When triple tests of support/resistance occur, breakouts tend to be more meaningful.

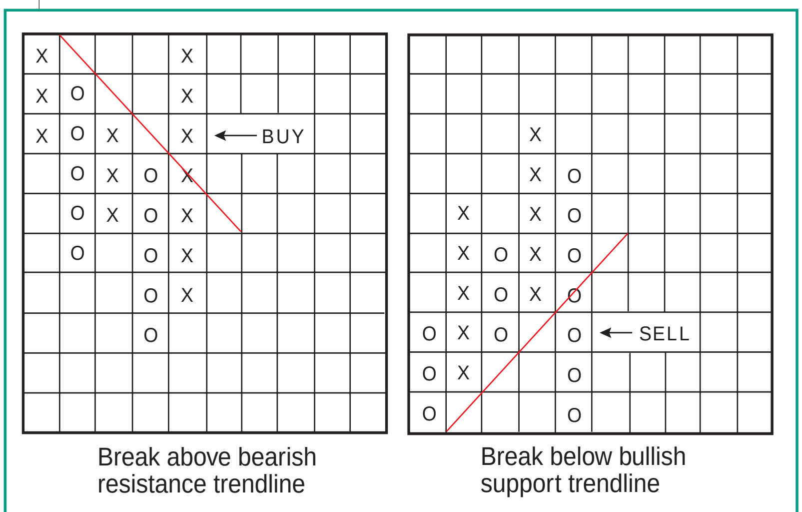

FIGURE 4: BREAK ABOVE BEARISH RESISTANCE AND BREAK BELOW BULLISH SUPPORT. Note the 45-degree angulations on P&F chart trendlines. Breakouts from well-formed P&F trendlines often tend to be decisive.

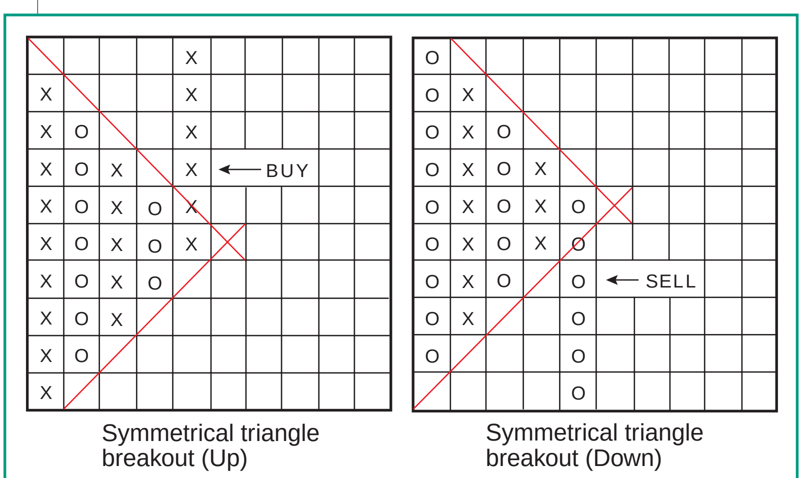

FIGURE 5: SYMMETRICAL TRIANGLE BREAKOUT (UP) AND SYMMETRICAL TRIANGLE BREAKDOWN (DOWN). When proper triangles form on P&F charts, breakouts tend to provide solid trading opportunities.

Triple tops and triple bottoms (Figure 3) are much less common than their double siblings. But when these triple tests of support/resistance occur, their breakouts tend to be more meaningful. As a guideline, the more tests of a given support/resistance line occur, the greater the significance of its eventual break.

Again, the requisite 45-degree angulation on P&F trendlines makes for a strict environment for determining dynamic support and resistance lines. Perhaps because of this, tradable trendlines on P&F charts are not nearly as prevalent as those on bar or candlestick charts. But when a good trendline does occur on a P&F chart, breakouts often tend to be decisive (Figure 4).

Triangles on P&F charts are also less prevalent than those on bar/candlestick charts. Among other reasons, this is due to the much stricter price criteria on P&F charts. But as with trendline breaks, when proper triangles form on P&F charts, breakouts tend to provide solid trading opportunities (Figure 5).

There was a time when these trading opportunities were becoming progressively scarce as P&F charting fell severely to the wayside, overshadowed by its more mainstream bar and candlestick cousins. But as traders and analysts have increasingly searched for innovative ways to interpret financial markets, P&F charts have recently enjoyed a surge of renewed popularity. This has especially been the case with forex traders.

Uniquely suited to the idiosyncrasies of trading the foreign exchange market, P&F charts have proven their worth as a classic and valuable tool in the forex trader's toolbox.

James Chen is the chief technical analyst for FX Solutions, a leading foreign exchange marketmaker. He is also a registered Commodity Trading Advisor (CTA). Chen conducts forex trading seminars and writes frequent articles and analytical reports on the currency markets. He may be reached via email at jchen@fxsol.com.

S&C